



Attachment – A-3
11/20/15

Isiah Leggett
County Executive

OFFICES OF THE COUNTY EXECUTIVE

Timothy L. Firestine
Chief Administrative Officer

November 20, 2015

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended September 30, 2015. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan ("GRIP"). There were approximately 5,525 ERS and GRIP active members and 6,420 retirees participating in the ERS as of September 30, 2015.

Performance Results

The total return achieved by the ERS assets for the quarter was a loss of 4.32%, 51 basis points ahead of the 4.83% loss recorded by the policy benchmark. For the one year period ending September 30, 2015 the ERS' gross return (before fees) was a loss of 0.30%, 200 basis points ahead of the 2.30% loss recorded by the policy benchmark. The one-year gross return places the ERS' performance in the second quartile of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 6.77% for the three-year period and 8.64% for the five-year period ranked at the third and first quartile of the universes, respectively. The asset allocation at September 30, 2015 was: Domestic Equities 19.1%, International Equities 15.3%, Global Equities 3.4%, Fixed Income 24.3%, Inflation Linked Bonds 10.8%, Commodities 2.9%, Private Equity 6.9%, Private Real Assets 5.6%, Private Debt 0.5%, REITS 5.5%, Opportunistic 3.4%, MLPs 0.8%, and Cash 1.5%. We estimate that the funded status of the ERS was 90% as of September 30, 2015. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

Major Initiatives

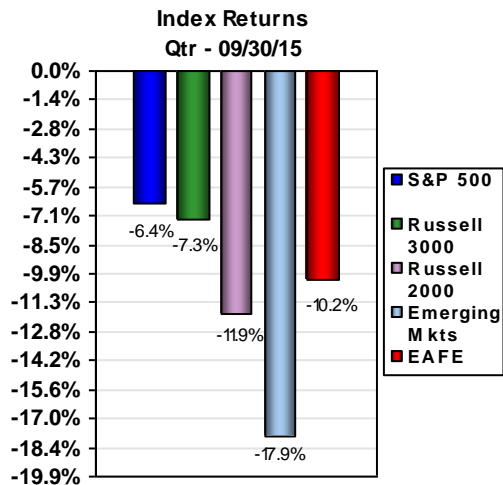
During the quarter, the following commitments were made: \$17 million to Clearlake Capital IV, LP, a special situations private equity fund, \$10 million to Clearlake Opportunities Fund, LP, a private debt fund, and \$8 million to Juniper Capital II, LP, a private energy real assets fund. In addition, Highclere International Investors, LLP was hired to manage an international small cap mandate and Cornerstone Real Estate Advisors, LLC was hired to manage global REITS.

Capital Markets and Economic Conditions

Economic data showed that GDP increased at a 1.5% annual rate in the third quarter, a decline of approximately 140 bps from the economy's second quarter expansion. The slowing rate of domestic economic growth during the most recent quarter is attributed to U.S. businesses continuing to work through gluts of capacity and excess inventory. However, strong domestic fundamentals appear to still

be intact (especially on the demand side), which are helping to offset supply concerns to fuel continued modest economic growth and expansion. Inexpensive fuel costs also continue to provide a tailwind for the consumer discretionary sector. Consumer spending, which accounts for approximately two-thirds of U.S. economic activity, rose 3.2% during the quarter. In addition to robust consumer activity, residential investment data was also healthy – a further sign that the housing market is positively contributing to the economic recovery. The economy added over 500,000 jobs during the third quarter and saw the unemployment rate fall to 5.1%. A strong U.S. dollar continued to put pressure on exports; however, trade's impact on GDP was relatively neutral due to a corresponding and offsetting slowdown in imports. Inflation also remained tame, as Core CPI posted a modest 1.3% growth rate during the quarter due in large part to persistent price pressure from the commodities sector.

Public Equity Markets: U.S. stocks closed the quarter down sharply on fresh concerns around global economic growth. A strong U.S. dollar continued to put pressure on earnings of multi-national firms, who have been increasingly looking to take advantage of low interest rates in the capital markets to lever up



their balance sheets in an effort to manufacture earnings growth non-organically. Large cap stocks generally outperformed small cap stocks, while growth lagged value. Nine of the ten sectors (with the exception being Utilities) of the S&P 500 Index recorded losses. Energy and Materials, fell 18.5% and 17.2%, respectively. Our combined domestic equity performance was a loss of 8.23%, underperforming the 7.25% loss recorded by the Russell 3000 benchmark.

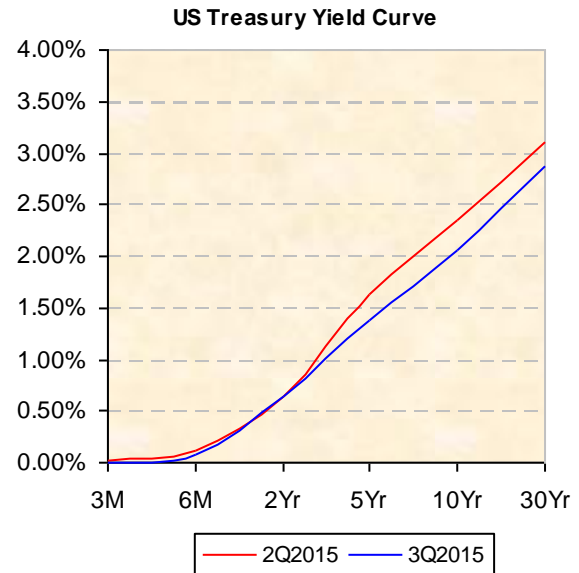
The European Central Bank (ECB) continued to provide liquidity in the form of Quantitative Easing (QE) in an effort to shore up a Eurozone economy which has seen recent little growth. Almost all emerging market countries saw precipitous equity market declines during the quarter, especially in commodity price sensitive regions such as Russia and Brazil. During the quarter, developed markets, as measured by the MSCI EAFE Index, were down 10.23, and Emerging Markets fell 17.90%. Our combined international

equity performance was a loss of 9.73% for the quarter, outperforming the 12.17% loss recorded by the MSCI ACWI ex-US Index. Global equities recorded a loss of 12.28%, underperforming the 9.45% loss of the MSCI ACWI benchmark.

Private Equity: Buyout funds raised approximately \$81 billion through the first three quarters of 2015, which is roughly on pace with the full-year 2013 and 2014 fundraising totals of \$107 billion and \$114 billion, respectively. However, investment activity in the buyout space has somewhat slowed, as the \$31 billion invested during the first three quarters represents a 23% drop from the same last year period. Pricing multiples have continued to expand from their peak of 9.3x in 2014 to 9.9x presently, while leverage multiples have dropped slightly from their peak in 2014. Venture capital activity has increased during the year, as the \$45 billion invested YTD through September 2015 has nearly matched the \$48 billion total investment made during all of 2014. Exit activity (primarily through IPOs and M&A transactions) in U.S. buyout and venture markets slowed a bit through the first three quarters of the year after a very active 2014. During the quarter, our private equity managers called a combined \$10.1 million and paid distributions of \$20.0 million. Our current allocation to private equity is 6.9%, with a market value of \$239.8 million. From its 2003 inception through March 31, 2015, the private equity program has generated a net internal rate of return of 8.7% versus a 12.2% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 bps).

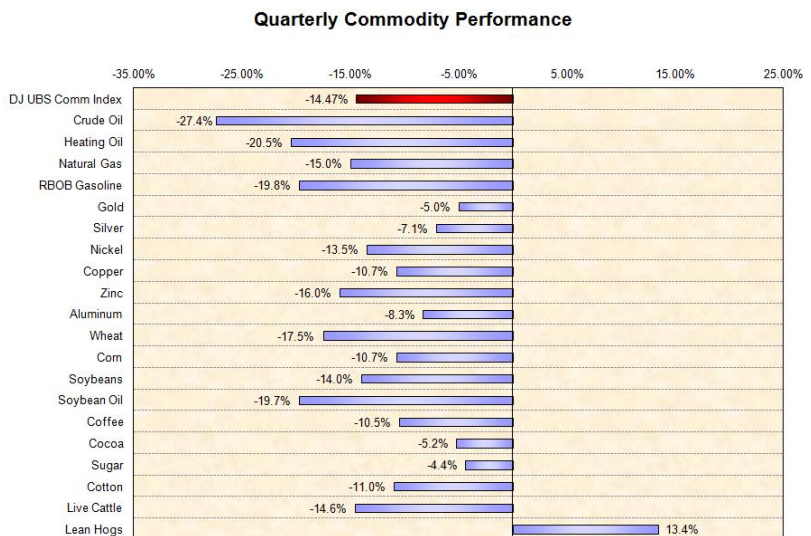
Opportunistic: Hedge funds, as measured by the HFRI Composite Index, lost 4.07% in the third quarter. Global Macro was one of the best performing opportunistic strategies, but still lost 0.66%, measured by the HFRI Global Macro Index. Hedge fund strategies with relatively high equity beta underperformed, as Event Driven strategies as measured by the HFRI Event-Driven Index were down 5.47% primarily due to downside volatility in the global equity markets. The opportunistic portfolio lost 2.42% in the third quarter, outperforming the HFRI Fund of Funds Index by 112 basis points.

Fixed Income: U.S. Treasury yields fell across the intermediate and long end of the yield curve during the quarter, as the Fed decided to further delay raising short-term interest rates. While the U.S. economy has expanded at a moderate pace and may be supportive of a rate rise, the Fed ultimately decided that global market conditions were not conducive to a tighter domestic monetary policy. Extreme volatility in the global equity markets further increased investor appetite for fixed income securities and led to additional compression in the yield curve. The yield on the 30 year bond declined 24 bps during the quarter, and ended the period at 2.87%. The yield curve flattened (shown in the chart to the right) as the spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, tightened by 28 bps to 142 bps. For the quarter, the 2-year Treasury yield ended at 0.64%, unchanged from the prior period, while the 10-year Treasury yield moved down by 28 bps to 2.06%. For the quarter, the Merrill High Yield Index declined by 4.88%, the Barclays Aggregate was up 1.23%, and the Barclays Long Govt/Credit Index rose 2.18% due to the aforementioned long end of the yield curve flattening. The fixed income performance for the quarter was a loss of 0.98%; slightly underperforming the custom benchmark's loss of 0.82%. Our global inflation-linked bond portfolio, combined with a portable alpha overlay, returned a negative 2.92% for the quarter, underperforming the benchmark's 0.71% loss.



Private Real Assets: Commercial real estate transaction values in the U.S. decreased by 6% quarter over quarter although these levels were 3% above Q3'14. The last twelve months (from Q4'14 to Q3'15) resulted in the highest transaction levels in the U.S. real estate market since 2007. In addition to increased volumes, capitalization rates for commercial real estate continued to decline to below 7% in Q3'15 from a peak of over 8% in early 2010. In the energy markets, U.S. oil prices decreased by over 20% during Q3'15 from approximately \$57 to \$45/barrel as market participants continue to be concerned about the oversupplied nature of the global oil markets. During the quarter, our private real assets managers called a combined \$4.0 million and paid distributions of \$11.7 million. Our current allocation to private real assets is 5.6%, with a market value of \$194.6 million. From its 2006 inception through March 31, 2015, the private real assets program has generated a net internal rate of return of 3.7% versus a 6.6% gain for the long-term benchmark CPI plus 500 bps.

Public Real Assets: The Bloomberg Commodity Index declined 14.5%, its largest quarterly decline since Q4 2008. The weakness was spread across all four major sectors and was driven by concerns that the Chinese economy is slowing and that many commodities continue to see supply growth. Within the energy sector, crude oil prices declined 27% on fears that supply continues to grow within the US while OPEC pumps near record levels. Weakness across the industrial metals sector resulted from rising production capacity and concern



over slowing Chinese demand as a key Chinese Purchasing Manager's index (PMI) fell to a six-year low. The agriculture and livestock sector declined as estimated crop yields for corn and soybeans were higher than expected after a rainy and wet start to the North American summer growing season in June. Lean

Hogs was the sole commodity within the index to advance due to increased exports. Continued US dollar strength and US economic stability weighed on precious metal prices, yet they were the strongest commodity sector on a relative basis. During the quarter, our commodities portfolio declined 14.41%, in-line with the benchmark.

Global listed real estate securities as measured by the FTSE EPRA/NAREIT Developed Index declined 1.63% for the quarter as valuations for publicly traded real estate companies lagged the appreciation in direct real estate. Consequently, the majority of public REITs are trading below their Net Asset Value (NAV) and this value gap has not gone unnoticed by private equity investors. The trend of REIT privatizations by major institutional investors continued during the quarter with notable REITs going private including Strategic Hotels and Quintain Estates, a UK residential developer. Our global REIT portfolio declined 1.44%, outperforming the benchmark by 19 bps.

Master Limited Partnerships, as measured by the Alerian MLP Total Return Index, declined 22.1% during the quarter due to the decline in oil price and a number of technical factors. There is a high degree of uncertainty regarding near-term US hydrocarbon production and subsequently the demand for midstream assets (i.e. pipelines, storage terminals). Further, several market participants have become net sellers due to margin call and tax-loss selling. For the quarter, our MLP portfolio declined 27.70%, underperforming the benchmark by 560 bps.

Additions

The primary sources of additions for the ERS include contributions from members and employers and investment income. The following table displays the source and amount of additions for the quarter ending September 30, 2015 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr 9/30/2015	Fiscal YTD
Employer Contributions	\$ 35.2	\$ 35.2
Member Contributions	6.1	6.1
Net Investment Loss	(166.1)	(166.1)
	\$ (124.8)	\$ (124.8)

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System Deductions by Type (millions)

	Qtr 9/30/2015	Fiscal YTD
Benefits	\$ 58.0	\$ 58.0
Refunds	1.9	1.9
Administrative Expenses	0.8	0.8
	\$ 60.7	\$ 60.7

Outlook

The Federal Reserve's long awaited first interest rate hike was further delayed in the third quarter as fresh concerns regarding slowing global growth (most notably in China and Europe) drove the Fed to keep the key-rate unchanged. While always one of the many variables under consideration, the Fed seemed to "formally" introduce the necessity of stability in foreign markets as a prominent driver in their domestic monetary policy decision making process. Unfortunately for investors, little clarity was provided on when a seminal shift in U.S. monetary policy may occur. Investors are now eyeing December as a likely time that the Fed will decide to finally lift rates off their 0% base.

A slowdown in economic growth across the world also caused periods of extreme volatility in the global equity markets during the quarter - especially for emerging market countries where mass investor de-risking was prevalent. Macro pressures in emerging markets will likely continue in the short-term due to a myriad of factors, most notably including a strong U.S. dollar, plunging commodity prices, and slower economic growth in China. The recovery in Europe continues to be slow in the face of the European Central Bank (ECB) pledging to continue with their quantitative easing (QE) program; however, long-term investors are finding pockets of opportunity due to the relative valuation attractiveness of the regions' equity markets.

Overall, it is likely that a pace of modest domestic economic growth will continue into the latter part of the calendar year, and further into the early stages of 2016 as the labor market continues to improve - albeit with wage growth that is closely tracking low levels of core inflation. An improved labor market coupled with depressed oil prices will likely continue to be a tailwind for consumer spending moving forward. Even if the Fed does act to increase short-term rates in the near future, the expectation is for long-term interest rates to remain low for a prolong period of time – providing further support for a housing market recovery which finally seems to be firmly be taking hold.

Sources: Bloomberg, Northern Trust, MSCI, S&P, T. Rowe Price, FRM, Wilshire Associates, Bridgewater, JP Morgan, BlackRock, PE Hub, Private Equity Analyst, Pitchbook, Real Capital Analytics, RE Alert, Schroder, Oil & Gas Investor.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF FIDUCIARY NET POSITION
September 30, 2015

Assets

Equity in pooled cash and investments	\$ 1,221,815
Investments:	
Northern Trust	3,463,981,953
Aetna	1,003,582
Fidelity - Elected Officials Plan	467,008
Fidelity - DRSP/DROP	3,528,216
Total investments	3,468,980,759
Contributions receivable	11,331,960
Capital assets	900,043
Less depreciation	(375,018)
Net capital assets	525,025
Total assets	3,482,059,559
Liabilities	
Benefits payable and other liabilities	5,901,727
Net position restricted for pensions	\$ 3,476,157,832

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN FIDUCIARY NET POSITION
September 30, 2015

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 35,186,244	\$ 35,186,244
Member	6,117,489	6,117,489
	<u>41,303,733</u>	<u>41,303,733</u>
Total contributions		
	<u>41,303,733</u>	<u>41,303,733</u>
Investment loss	(162,028,011)	(162,028,011)
Less investment expenses	4,112,401	4,112,401
	<u>4,112,401</u>	<u>4,112,401</u>
Net investment loss	(166,140,412)	(166,140,412)
	<u>(166,140,412)</u>	<u>(166,140,412)</u>
Total deletions		
	<u>(124,836,679)</u>	<u>(124,836,679)</u>
Deductions		
Retiree benefits	43,219,067	43,219,067
Disability benefits	12,540,778	12,540,778
Survivor benefits	2,279,473	2,279,473
Refunds	1,854,775	1,854,775
Administrative expenses	772,640	772,640
	<u>772,640</u>	<u>772,640</u>
Total deductions		
	<u>60,666,733</u>	<u>60,666,733</u>
Net decrease	<u>(185,503,412)</u>	<u>(185,503,412)</u>
Net position restricted for pensions		
Beginning of period	<u>3,661,661,244</u>	<u>3,661,661,244</u>
End of period	<u>\$ 3,476,157,832</u>	<u>\$ 3,476,157,832</u>